

after leveling is the highest permitted actual deferral ratio. Thus, for each highly compensated employee, the amount of excess contributions for a plan year is equal to the employee's elective contributions, plus qualified nonelective contributions and qualified matching contributions taken into account in determining the employee's actual deferral ratio under paragraph (g)(1) of this section, minus the amount determined by multiplying the employee's actual deferral ratio (determined after application of this paragraph (f)(2)) by the compensation used in determining the ratio. In no case may the amount of excess contributions to be recharacterized or distributed for a plan year with respect to any highly compensated employee exceed the amount of elective contributions made on behalf of the highly compensated employee for the plan year.

(3) *Recharacterization of excess contributions*—(i) *General rule.* Excess contributions are recharacterized in accordance with this paragraph (f)(3) only if the excess contributions are treated as described in paragraph (f)(3)(ii) of this section, and all of the conditions set forth in paragraph (f)(3)(iii) of this section are satisfied.

(ii) *Treatment of recharacterized excess contributions.*

(A) Excess contributions recharacterized under this paragraph (f)(3) are includable in the employee's gross income on the earliest dates any elective contribution made on behalf of the employee during the plan year would have been received by the employee had the employee originally elected to receive the amounts in cash, or on such later date permitted in paragraph (f)(3)(iv) of this section. The recharacterized excess contributions must be treated as employee contributions for purposes of section 72, section 401(a)(4) and 401(m), and paragraphs (b) and (d) of this section. This requirement is not treated as satisfied unless:

(I) The payor or plan administrator reports the recharacterized excess contributions as employee contributions to the Internal Revenue Service and the employee by—

(I) Timely providing such forms as the Commissioner may designate to the employer and to employees whose

excess contributions are recharacterized under this paragraph (f)(3); and

(ii) Timely taking such other action as the Commissioner may require; and

(2) The plan administrator accounts for the amounts as contributions by the employee for purposes of sections 72 and 6047.

(B) Recharacterized excess contributions continue to be treated as employer contributions that are elective contributions for all other purposes under the Internal Revenue Code, including sections 401(a) (other than 401(a)(4) and 401(m)), 404, 409, 411, 412, 415, 416, and 417. Thus, for example, recharacterized excess contributions remain subject to the requirements of paragraph (c) of this section; must be deducted under section 404; and are treated as employer contributions described in section 415(c)(2)(A) and § 1.415-6(b). In addition, these amounts are not treated as compensation for purposes of sections 404 and 415, and may be treated as compensation for purposes of sections 401(a)(4), 401(a)(5), 401(k), 401(l) and 414(s) only to the extent that elective contributions may be treated, and are treated under the plan, as compensation. See § 1.414(s)-1(c)(4)(i). Recharacterized excess contributions that relate to plan years ending on or before October 24, 1988, may be treated as either employer contributions or employee contributions for purposes of paragraph (d) of this section. The amount of excess contributions included in an employee's gross income is reduced as provided under paragraph (f)(5)(i)(B) of this section.

(iii) *Additional rules*—(A) *Time of recharacterization.* Excess contributions may not be recharacterized under this paragraph (f)(3) after the later of October 24, 1988, or 2½ months after the close of the plan year to which the recharacterization relates. Recharacterization is deemed to have occurred on the date on which the last of those highly compensated employees with excess contributions to be recharacterized is notified in accordance with paragraph (f)(3)(ii)(A) of this section. The Commissioner may designate the means by which this notification is to be provided.

(B) *Employee contributions must be permitted under plan.* The amount of recharacterized excess contributions, in combination with the employee contributions actually made by the highly compensated employee, may not exceed the maximum amount of employee contributions (determined without regard to the actual contribution percentage test of section 401(m)(2)) that the highly compensated employee could have made under the provisions of the plan in effect on the first day of the plan year in the absence of recharacterization. See § 1.401(m)-1(a)(2) for requirements relating to the availability of employee contributions.

(C) *Plans under which excess contributions may be recharacterized.* For plan years beginning after December 31, 1991, elective contributions may be recharacterized under this paragraph (f)(3) only under the plan under which they are made or under a plan with which that plan could be aggregated under § 1.410(b)-7(d) after application of the mandatory disaggregation rules of § 1.410(b)-7(c), as modified in § 1.401(k)-1(g)(11). For plan years beginning before that date and after December 31, 1988, or such later date provided under paragraph (h) of this section, elective contributions may be recharacterized under this paragraph (f)(3) only under the plan under which they are made or under a plan with the same plan year as that plan.

(iv) *Transition rules.* If amounts recharacterized for any plan year were not previously included in income, they must be treated as received by employees for income tax purposes on the first day of the first plan year ending after 1987. If notice of recharacterization was provided to the affected highly compensated employees by October 24, 1988, recharacterization is deemed to have occurred 2½ months after the close of the plan year and the penalty tax of section 4979 will not be imposed. The rules in this paragraph (f)(3)(iv) are effective only for plan years ending before August 9, 1988.

(v) *Example.* The provisions of this paragraph (f)(3) are illustrated by the following example:

*Example.* (i) Employer X maintains Plan Y, a calendar year profit-sharing plan that includes a qualified cash or deferred arrange-

ment. Under Plan Y, each eligible employee may elect to defer up to 10 percent of compensation under a salary reduction agreement. An eligible employee may also make employee contributions of up to 10 percent of compensation. X pays the amounts deferred to the trust on the last day of each month. Employer X includes elective contributions in compensation as permitted under § 1.414(s)-1(c)(4)(i). See § 1.401(k)-1(g)(2)(i). Salaries are paid on the same date.

(ii) (A) In January 1989, X determines that during 1988 the compensation and actual deferral ratios (ADRs) of X's six employees were as follows:

Employee	Compensation (A)	Elective contribution (B)	ADR (%) (B/A)
A .....	\$70,000	\$7,000	10.00
B .....	60,000	4,500	7.50
C .....	20,000	1,000	5.00
D .....	15,000	0	0
E .....	10,000	350	3.50
F .....	10,000	350	3.50

(B) The average deferral percentage (ADP) for X's highly compensated group, A and B, is 8.75 percent  $((10.00\% + 7.50\%) / 2)$ . The ADP for X's other employees is 3 percent  $((5.00\% + 0\% + 3.50\% + 3.50\%) / 4)$ . Because 8.75 percent is more than 2 times 3 percent and more than 3 percent plus 2 percentage points, the plan fails to satisfy paragraph (b)(2) of this section. Neither A nor B made any employee contributions for the year.

(iii) Plan Y provides that each highly compensated participant will have excess contributions, as defined in paragraph (g)(7) of this section, recharacterized. The amount to be recharacterized will be determined according to the method described in paragraph (f)(2) of this section.

(iv) In order to satisfy paragraph (b)(2) of this section, Plan Y must reduce the ADP for X's highly compensated employees to not more than 5 percent. This will satisfy the test described in paragraph (b)(2) of this section, because 5 percent is not more than 2 times 3 percent and is not more than 2 percentage points greater than 3 percent. Plan Y first reduces A's ADR to 7.5 percent (the ADR of the highly compensated employee having the next highest ADR). Since this is not sufficient to satisfy the ADP test in paragraph (b)(2) of this section, the ADR of both A and B must be reduced to 5 percent.

(v) The maximum dollar amount that may be deferred by each employee is determined by using the formula  $D = (ADR \times S)$  where D is the maximum allowable deferral, ADR is the reduced ADR, and S is the compensation. Thus, A's maximum allowable deferral is \$3,500  $(.05 \times \$70,000)$ , and B's maximum allowable deferral is \$3,000  $(.05 \times \$60,000)$ . The balance of the original deferrals by A and B